Growing Strong Together

Montana State Fund

Nineteen Ninety-Seven Annual Report

Fiscal Year 1997 Key Business Highlights

- Consolidated Premium Audit and Loss Control services into the Underwriting Department
- Approved an overall 5.6% rate decrease effective July 1, 1997
- Reached overall customer satisfaction level of 92.1%
- Merged the Customer Service and First Reporting Units
- Expanded our Large Account Unit to underwrite all accounts $10,000 and above
- Reduced loss ratio for selected accounts by 40.8% from fiscal year 1996, saving 150 customers $3.2 million
- Recovered $1,529,057 in workers' compensation fraud through savings on reserves, restitution, and ordered premium
- Contributed $102.3 million to the Old Fund liability to retire debt
- Passed legislation to contribute additional $63.8 million to the Old Fund to help eliminate tax
- Referred 88.4% of injured workers with lost time claims into a managed care organization
- Passed legislation to work with licensed insurance producers and add two new board members
- Established two new association plans with the Montana Building Industry Association and the Montana Stockgrowers Association
- Employee satisfaction improved 6.4% over the past three years
- Lowered injury reporting time for employers: 80% of employers reported injury within 14 days

Montana State Fund Board of Directors

left to right: Herb Leuprecht, Jim Brouelette, Laurie Shadoan, Tom Horn, Jack Morgenstern, Carl Swanson

Message from the Chair

During fiscal year 1997, the Montana State Fund took the leadership position in the workers' compensation industry through its dedication to serving the needs of Montana employers and their employees. With improved customer satisfaction and financial stability, we concentrated on building strong business partnerships. Now, strengthened by an ever-expanding statewide network of licensed insurance producers, and bolstered by our strategic planning process, we continue to devote energy and resources to enhance programs and market stability.

Our commitment to address customer requests while maintaining an appropriate customer base is reflected in our daily operations. Our strategic business plan established two fundamental goals for the State Fund: *providing quality customer service* and *managing our resources effectively*. By fostering community-based partners, we are addressing both goals simultaneously. With the active support of Governor Racicot, the Montana Legislature, and the local insurance community, the State Fund was authorized to provide services through licensed insurance producers. This change facilitates our ability to add value to our products and services and provide local service to our customers. Today, we are working toward a network of licensed insurance producers in every Montana community. We are also striving to expand our association partnerships which are designed to provide unique, value-added services and improved workplace safety. As our medical provider managed care network expands, we will continue to provide quality care for injured workers while containing workers' compensation costs for our customers.

The State Fund operates in a very dynamic and competitive environment. Our success in the past and our continued progress in the future are dependent upon our ability to anticipate and respond rapidly to service expectations and industry change. The State Fund's solid financial position, strong relationships with customers and insurance producers, and the entrepreneurial spirit within our employee family will allow us to continue to maintain a quality customer base and stability within the workers' compensation system.

We have accomplished a great deal over the past few years and we thank all of our customers for their thoughtful comments and patience as we set out to resolve the issues before us. In closing, we give special thanks to the professional, dedicated staff that has given a great deal of themselves to make the Montana State Fund the driving force it is today.

Respectfully,

Jim Brouelette
Chairman of the Board

Montana State Fund Executive Staff

Back row: Mark Barry, VP Administration and Finance; Eivind Nilsen, VP Management Information Services; Carl Swanson, President/CEO; Michael Glass, VP Underwriting; Jim McCluskey, VP Claim

Front Row: Nancy Butler, VP Legal; Joanne Shydian, VP Human Resources

President's Letter

There is a sense of momentum within the Fund today that is very exciting. Our employees are achieving targeted results largely through a commitment to extraordinary customer service, financial stability, and industry leadership. As a result of this commitment, *tremendous* and *significant* progress occurred in fiscal year 1997. Our performance, in large part, was due to the work we started four years ago, when we began to strengthen our financial position, focus on our strategic planning process, establish effective partnerships within the industry, and commit to our human resources.

The emphasis in 1997 was to develop and implement programs to expand our presence in local communities through licensed insurance producers, assist our customers in improving the safety of their workplaces, and better manage and control claim costs. In fiscal year 1997, we made considerable progress to position our organization to maintain industry stability and participate in expanded customer service efforts.

Some important milestones in 1997 were:

▲ A partnership with fourteen local insurance agencies was piloted as a result of Senate Bill 67

▲ Implementation of a new Benefit Information System with imaging and work-flow efficiencies

▲ The third consecutive year of rate decreases for employers and a cumulative 36% over the past three years

▲ A return to work emphasis to reduce claim costs and insurance premiums

▲ Policyholder satisfaction service level of 92.10 percent

▲ Injured worker satisfaction with overall claim process (indemnity) up 85.4% from benchmark (July 1995)

The strong progress achieved has required a significant change in the structure and culture of our organization. Our focus has been to move the State Fund to a dynamic and competitive leader in the industry. This year, our organization has demanded immeasurable time from our employees. I thank them for not only the fine results achieved, but their vitality, resourceful and creative ideas, and energetic commitment. Our mission and vision have lead us to do a better job of meeting a broad spectrum of customer needs while enhancing resources and skills across the organization. Although our mission is never completely accomplished, we continue to strive to meet the challenges ahead and be the industry leader and provider of choice that you deserve.

Sincerely,

Carl Swanson
President/CEO

Introduction

The State Fund is a leader in workers' compensation insurance and the largest single insurer in Montana, serving over 24,000 customers. We are a unique self supporting, non profit, competitive insurance carrier created by the State of Montana in 1990. A key purpose is to ensure an available market to all Montana employers for workers' compensation insurance and to help make workplaces safe while remaining competitive in the open market. By achieving this goal, we maintain fair workers' compensation premium rates for employers and industry stability.

When work related injuries occur, the State Fund's goal is to return the injured workers to their jobs, facilitate strong communications, and ease personal suffering. The State Fund offers leading edge programs to enhance workplace safety, early reporting of injuries, providing benefits and quality medical care to injured workers, and establishing return to work opportunities. The State Fund has six integrated departments: Underwriting, Claim, Legal, Human Resources, Administration & Finance, and Management Information Systems. The employees of the State Fund have specialized backgrounds in areas, such as, underwriting, loss control, claim management, early return to work, legal, and fraud.

Here are the characteristics that we believe separate us from our competitors:

- Placing our customers first and being an industry leader in service.
- Focusing on the treatment of injured workers through quality managed care services and early return to work programs.
- Maintaining the highest professional standards and being the carrier of choice.
- Realizing that working together allows us to achieve common goals.
- Guiding our actions by respect, honesty, and integrity.

In fiscal year 1997, a five member Board of Directors governed the State Fund. As a result of SB76, the Board is being expanded to seven members in fiscal year 1998. All board members are appointed by the Governor. We are audited annually by the Legislative Audit Division of the State of Montana and our assets are invested and managed by the Montana Board of Investments.

State Fund Facts:

Number of Policyholders	24,823 as of 6/30/97 Total policies serviced 28,829
Reported policyholder payroll	$1,012,550,136
Earned premium	$88,153,877
Average premium per policy	$3,058
New policies serviced	4,755
Number of claims reported	13,656
Number of employees (FTE's)	232.75
FY97 operating expenses	$11,373,573
Investment Income	$32,253,776
Equity in FY97	$159,425,628
Total Fraud Savings since Unit inception (FY93)	$6.5 million

The Montana State Fund is growing strong

Fiscal year 1997 emerged as a year of opportunities, action, and change. Opportunities to expand our service through a partnership with insurance producers has restructured, in large part, the way we conduct our business. We grew stronger through the addition of two new association programs—the Montana Building Industry Association and the Montana Stockgrowers Association. These programs focus heavily on workplace safety, early reporting, and early return to work. We introduced a new benefit information system (BIS) which transformed our paper files onto imaged computer documents making us more efficient and lowering claim costs. Near the end of the fiscal year, we consolidated two departments in our company - Underwriting and Premium Audit/Loss Control and Customer Service - to provide customized, integrated services to all customers. The driving forces behind these State Fund changes has been *enhanced customer service and better resource management*

"Here at Lattice Materials Corp., we know that our employees value stability and predictability in their work environment and responsibilities. An injury can shatter this sense of stability, and threaten employees' confidence and self-worth. Creating a partnership with the Montana State Fund means employees are treated with quality care and responsive service. We let our workers know that they belong here-and are valuable to us!"

-John Tengelsen, CEO Lattice Materials

John Tengelsen, CEO

Lattice Materials

Lattice Materials manufactures silicon and germanium parts for the infrared and laser optics industry.

Brad Brown

Glacier Nursery

"The State Fund has been responsive to my needs, both in rate setting and claims service. In the last four years, my payroll has quadrupled, yet my workers' compensation premium has decreased by one-third. Having a local claims adjuster familiar with the local medical community and able to visit injured workers on the job site is quite beneficial."

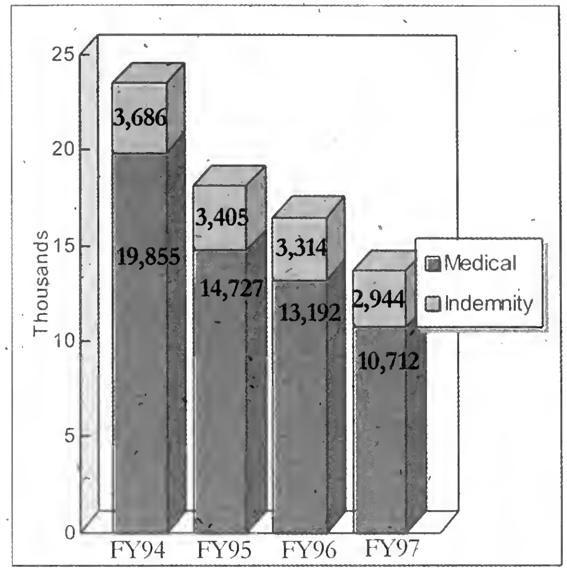
Brad Brown of Glacier Nursery in Kalispell.

A Glacier Nursery employee trims trees during the winter.

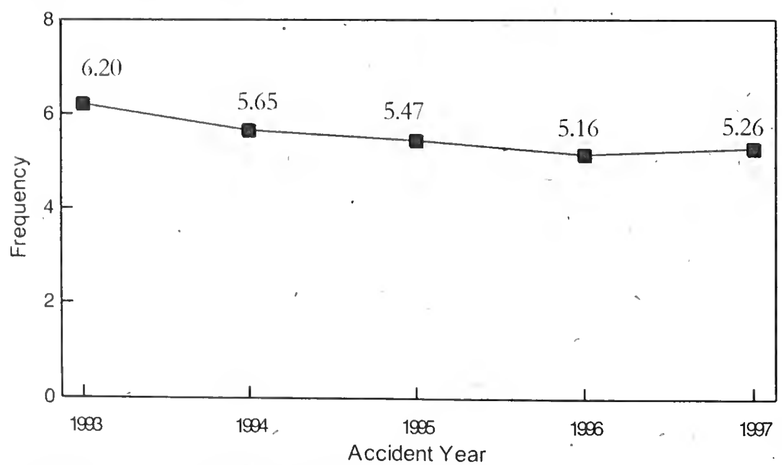
Our integrated strategy to lower claim costs

On the job injuries are never scheduled and when they occur, an instant response is critical. The State Fund is committed to providing employers and their injured workers with immediate attention. We are focused on building strong links between the injured workers and our claim staff, while keeping the employer and the medical provider involved and informed. Our leading strategy involves the immediate reporting of all work related injuries, a superior network of managed care providers, a medical case manager and claim adjuster team, and a specialized program for early return to work. This people to people approach enhances communications, reduces suffering and returns employees back to work more quickly, ultimately lowering overall claim costs. In addition, advanced technology in our claim department virtually eliminates the need for paper files. Immediate access to and dissemination of information will improve claim management by saving time, ensuring quality and consistency, and improving overall customer service.

Reported Claims

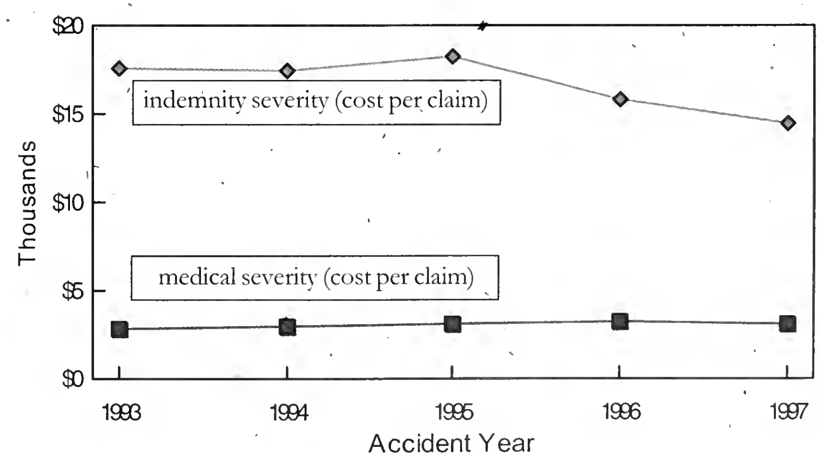


Loss Frequency Trend



Frequency—losses per $1 million reported payroll

Loss Severity Trend



Representing local communities

In fiscal year 1997, the State Fund took critical steps to ensure legislative actions would be implemented to improve our leadership, enhance service, and provide measurable results. When we began our operations in 1991, the State Fund was solely a direct writer of workers' compensation insurance. This year, we began a pilot program partnering with licensed insurance producers. This change, endorsed by the Governor, Montana Legislators, employers, and the insurance industry, is a significant component to our marketing efforts and the distribution of our services. The program enables employers to work with one producer for all their insurance needs, if they desire, and delivers the highest quality of services through knowledgeable local producers. We also believe this step builds greater confidence in the workers' compensation system and improves market stability.

Additional legislative action enabled the State Fund to add two new board members in fiscal year 1998. This step will make our leadership stronger and continue to make us a dynamic competitive carrier in the marketplace.

"We have witnessed significant improvements in the workers' compensation insurance industry as a result of the State Fund's leadership. Rates are down, their management is on track, and the overall climate is more competitive. This improves service to Montana employers."

-Don Allen, Executive Director
Coalition for Work Comp System Improvement

"The Montana Chamber of Commerce appreciates the State Fund's efforts to enhance its viability in recent years which has been a key to curtailing the workers' compensation crisis. We have always supported a competitive workers' compensation environment in Montana and recognize the importance of the State Fund as an integral component in this equation."

-David Owen, Executive Director
Montana Chamber of Commerce

"The State Fund has developed significant advances in workers' compensation and has played a major role in the reform to lower rates and improve workplace safety. I remain very committed to the State Fund and now have the opportunity to work directly with my insurance agent for coverage."
-Joe Wolfe, Polar Electric

Nikki Smith of Western States Insurance joins Joe and Bonnie Wolfe of Polar Electric.

Left: Bonnie and Joe Wolfe listen as Nikki Smith explains their workers' compensation insurance.
Below: Nikki Smith of Western States Insurance Agency in Helena shakes hands with Joe Wolfe of Polar Electric.

Aggressive Fraud Prevention

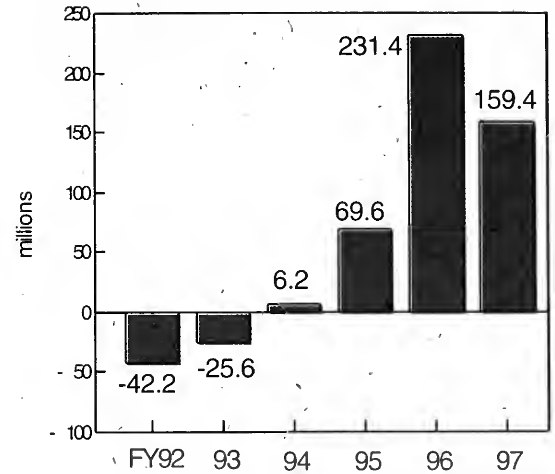
Our successful fight against fraud is an achievement we are proud of and one that has contributed to the reduction in employer costs. The State Fund's special fraud unit has marked success with over $7 million in total savings, over 1,000 investigations, and 40 convictions. In fiscal year 1997, we worked diligently with the Department of Justice. Our largest source of referrals were from internal claim adjusters and our fraud hotline. Our overall fraud savings in fiscal year 1997 which included premium ordered, restitution, and reserve savings was $1.52 million, and our return on investment was 2.9:1.

Customer Assistance Programs

The State Fund has developed a number of special programs for employers and employees. One of our leading programs is our accident prevention and safety services. The State Fund employs loss control specialists who offer individual and industry-specific safety services. Policyholder services include safety seminars and training, job site surveys, accident analysis, program development, and guidance on effective hiring. The success of these programs is clearly reflected in our reduced loss frequency and loss severity trends.

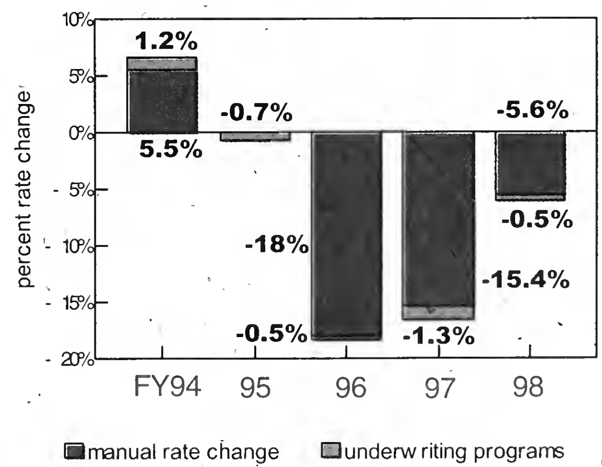
We also continued our extensive policyholder education and training program—Workers' Compensation Fundamentals. This program is designed to teach employers how to lower losses, manage costs, and take control of work related injuries. We continued to seek public input and customer feedback at our community presentations.

Fund Equity



$72 million decrease due to $102 million dividend to Old Fund which was used to retire debt. The $102 million reduction was partially offset by $30 million net income, resulting in a net $72 million reduction in fund equity.

Premium Rate Changes



Hanser's Automotive & Wrecking

Hanser's Automotive is located in Billings. It includes a vehicle repair shop, vehicle disassembly facility, and automotive transmission rebuild shop.

"One of the most influential steps taken at Hanser's has been to involve all employees and their spouses in our safety meetings. We build a community and recognize the importance of family."

-Ralph Hanser, Owner

"We have been so impressed with the changes at the State Fund. Whenever I contact the State Fund, they are always very helpful and wonderful to work with. It's the positive attitude and focus on safety that makes a difference."

-Peggy Akerstrom, Hanser's Safety Coordinator

"The Montana State Fund, in the last five years, has become a recognized leader in Montana's workers' compensation industry, working professionally and diligently to provide more personal service, increase safety for employers and employees, and making insurance premiums more affordable for small business. The National Federation of Independent Business (NFIB) is pleased to have launched in 1997 a working relationship with the Montana State Fund that will assist this positive growth in the years ahead. Small business is the engine that drives Montana's economy, and NFIB recognizes that safety in the workplace, coupled with an affordable and much improved workers' compensation system, is critical to the health and well being of Montana's small and independent business owners and their employees."

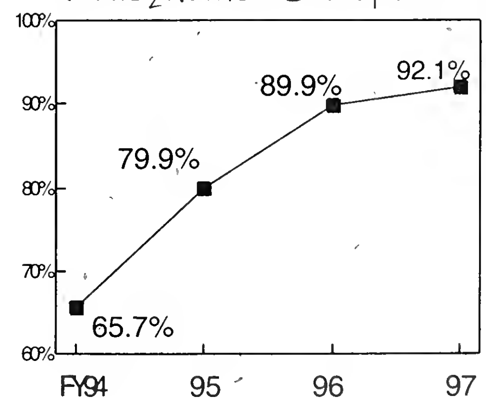
-Riley Johnson, Executive Director
National Federation of Independent Businesses

Improvements in Service

Through surveys, focus groups, and one-on-one interviews, we asked customers about the quality of our services and the professionalism of our employees. We were delighted with many of the comments provided on the returned surveys and we also learned what areas of improvement were needed. In 1996, we established a key strategic business plan goal to achieve and maintain 85% overall customer satisfaction. For the past two years we have surpassed our goal—reaching 92.1% this year. Furthermore, we reached a 95% level of satisfaction with policy services, 94.6% with loss control and safety, and 93.2% in claim management. We also make it a priority to receive feedback from injured workers related to the claim process. Again this year we saw significant improvement.

This year, 76% of our injured workers (closed cases in fiscal year 1997) who experienced an indemnity loss were satisfied or very satisfied with the overall claim process, up from 69% last year. Our managed care organizations also received a positive rating of 78% satisfaction with the MCO referral process. In our efforts to encourage further customer participation, we conducted our second phase of employer focus groups. These provided important information about our billing and reporting procedures to incorporate in our new policy services computer system. Our customers expect courteous service, responsive communications, and solutions to problems. The State Fund strives to deliver these service levels to our employers and their employees.

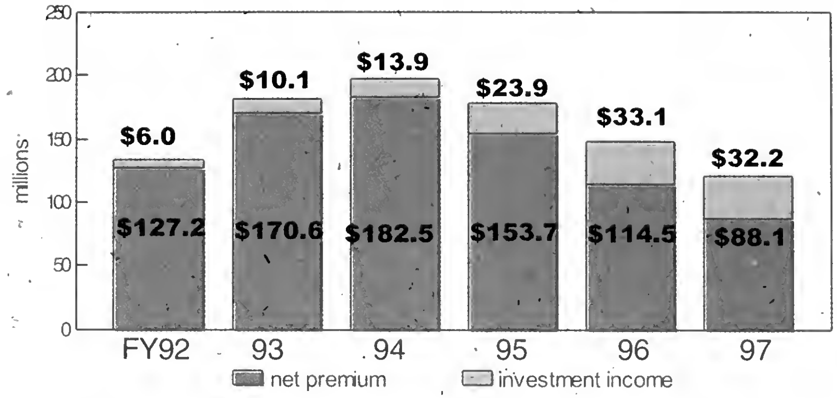
Policyholder Satisfaction



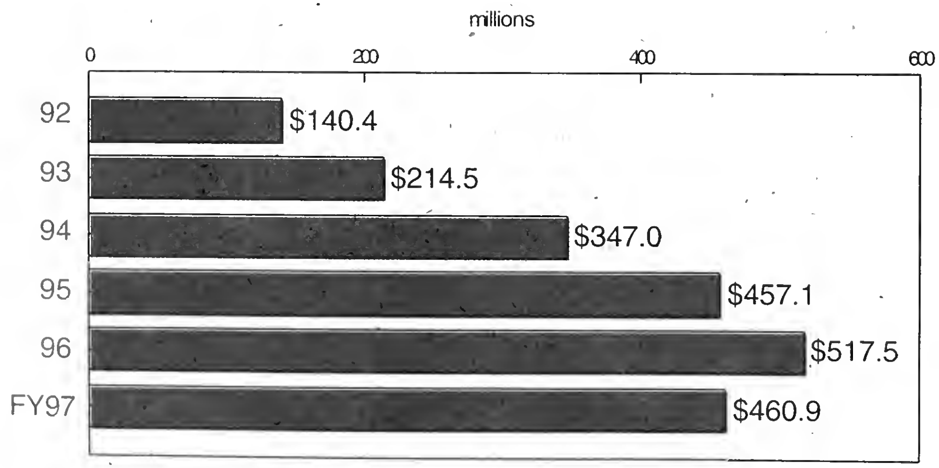
Assuring the Future

Is all this change essential? We believe that our customers expect and deserve much more today from their insurance carrier. The State Fund is striving to exceed our customer's expectations and lead the industry to continual improvement. In order to be a leader, we know that listening, responding, and implementing change are of paramount importance. Our deepest appreciation to the leaders of our state, our strategic business partners, the Independent Insurance Agents and Professional Insurance Agents, our customers and our employees for making these changes possible. We enthusiastically thank you for your contributions to our success. As our mission clearly states, the Montana State Fund is committed to be an industry leader in service and insurance carrier of choice for Montana employers.

Net Premium and Investment Income



Total Invested Assets



The decrease in invested assets is the result of a $102 million dividend paid to the Old Fund coupled with net cash flow from operations.

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel
Tori Hunthausen, IT & Operations Manager

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Balance Sheets, New and Old Funds, of the State Compensation Insurance Fund, a component unit of the State of Montana, as of June 30, 1997 and 1996, and the related Statements of Operations and Changes in Fund Equity, New and Old Funds, and Statements of Cash Flows, New and Old Funds, for the two fiscal years then ended. The information contained in these financial statements is the responsibility of the State Compensation Insurance Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Compensation Insurance Fund, as of June 30, 1997 and 1996, and the results of its operations and of its cash flows for the two fiscal years then ended in conformity with generally accepted accounting principles.

As described in note 1 to the financial statements, the State Compensation Insurance Fund implemented the Governmental Accounting Standards Board (GASB) Statement No. 28 - Accounting and Financial Reporting for Securities Lending Transactions effective July 1, 1996. The financial statements for the year ended June 30, 1996 have been restated to reflect securities lending transactions in accordance with this new GASB statement.

Respectfully submitted,

James Gillett

James Gillett, CPA
Deputy Legislative Auditor

October 20, 1997

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Financial Statements

The Montana State Fund is a component unit of the State of Montana.

New Fund Balance Sheet
(with comparison to prior fiscal year end)

(thousands of dollars)

	As of June 30, 1997	As of June 30, 1996 (as restated)
Assets		
Cash in Treasury	$2,717	$1,223
Short-term Investment Pool (Note 1)	25,473	36,254
Premium Receivable (Note 1)	13,342	13,372
Allowance for Doubtful Accounts	(419)	(318)
Due from Other Funds	1,858	1,806
Interest Receivable	6,688	7,407
Short-term Notes & Loans Receivable	117	97
Long Term Securities (Note 1, 2)	340,967	337,530
Securities on Loan (Note 1)	94,430	143,772
Cash Collateral - Securities on Loan (Note 1)	100,496	139,385
Supplies Inventory	49	58
Equipment	3,864	3,508
Less Accumulated Depreciation	(2,053)	(1,540)
Intangible Assets	6,400	3,249
Property Held in Trust	494	806
Other Assets	5	4
Total Assets	$594,428	$686,613
Liabilities		
Estimated Claims Liability (Note 4)	$315,107	$294,478
Liability for Securities on Loan	100,496	139,385
Unearned Premium	16,387	17,674
Security Deposits (Note 1)	695	1,028
Accounts Payable	944	1,087
Due to Other Funds	693	920
Compensated Absences (Note 8)	680	608
Total Liabilities	$435,002	$455,180
Fund Equity		
Contributed Capital	$0	$11,599
Unrestricted	159,426	219,834
Total Fund Equity	$159,426	$231,433
Total Liabilities and Fund Equity	$594,428	$686,613

The notes are an integral part of the financial statements.

Notes to Financial Statements
for the two Fiscal Years ended June 30, 1997

1. Summary of Significant Accounting Policies

Description of Business

The State Compensation Insurance Fund (State Fund) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Codes Annotated (MCA). The State Fund provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana.

During the two fiscal years ended June 30, 1997, the State Fund was governed by a five member Board of Directors appointed by the Governor. The Board of Directors increased to seven members effective July 1, 1997. The State Fund is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund.

The New Fund functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of the New Fund are separate and distinct from assets, debts, and obligations of the State of Montana. Upon dissolution of the New Fund, any monies not needed to liquidate the New Fund would be subject to legislative provision according to state law (Section 39-71-2322, MCA). The State Fund administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity

New Fund Statement of Operations and Changes in Equity

(with comparison to prior fiscal year end)

(thousands of dollars)	Fiscal Year Ending June 30, 1997	Fiscal Year Ending June 30, 1996 (as restated)
Underwriting Results		
Premium	$89,142	$115,574
Less: Reinsurance Premium Paid	(334)	(519)
Safety Incentive Refunds	(320)	(236)
Volume Discounts	(334)	(360)
Claims Expenses:		
Compensation Benefits Paid	33,421	42,218
Medical Benefits Paid	23,694	28,596
Allocated Loss Adjustment Expenses	1,262	713
Change in Estimated Claims Liability	20,630	(101,360)
Other Expenses:		
Operating Expenses	10,940	12,583
Bad Debts	433	3,531
Underwriting Gain/(Loss)	($ 2,226)	$128,178
Investment Income (Note 1)	31,874	32,835
Securities Lending Income (Note 1)	7,403	8,869
Securities Lending Expense (Note 1)	(7,023)	(8,579)
Other Income	250	517
Results of Operations	$30,278	$161,820
Gain on Sale of Fixed Assets	4	1
Net Income (Loss)	$30,282	$161,821
Residual Equity Transfer - Dividend (Note 7)	(90,690)	
Return of Contributed Capital (Note 7)	(11,599)	
Prior Year End Fund Equity (as previously reported)	231,433	69,597
Fund Equity as Restated	$159,426	$231,418
Prior Year Adjustment		15
End of Period Fund Equity	$159,426	$231,433

The notes are an integral part of the financial statements.

related to receipt and disbursement of an Old Fund Liability Tax (see note 4, Old Fund). No State general fund money is used for State Fund operations.

Because of the Governor's appointment of the board members and the state's regulatory oversight function, the State Fund financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report.

Basis of Accounting

The State Fund uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, the State Fund records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Cash and Short Term Investment Pool

Cash balances include demand deposits with the State Treasury. The State Fund also participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. There are no legal risks that the Board of Investments is aware of regarding any STIP investments. (The market value of STIP amounts approximate cost.) The New Fund STIP balance of $25,472,672 as of June 30, 1997 represented 2.3 % of the total STIP. The Old Fund STIP balance of $20,789,495 as of June 30, 1997 represented 1.9% of the total STIP. The New Fund STIP balance of $36,254,100 as of June 30, 1996 represented 3.1% of the total STIP. The Old Fund STIP balance of $7,402,425 as of June 30, 1996 represented 0.6% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The Board of Investment's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The six NRSRO's include Standard and Poors, Moody's, Duff and Phelps, Fitch, International Bank Credit Agency and Thompson's Bank Watch.

New Fund Statement of Cash Flows (with comparison to prior fiscal year end)

(thousands of dollars)

	Fiscal Year Ending June 30, 1997	Fiscal Year Ending June 30, 1996 (as restated)
Cash Flows from Operating Activities		
Receipts for Premiums	$86,808	$113,008
Payments to Suppliers for Goods and Services	(4,128)	(5,328)
Payments to Employees	(6,676)	(7,000)
Cash Payments for Claims	(58,345)	(71,452)
Other Operating Revenues	206	482
Net Cash Provided by (Used for) Operating Activities	**$17,865**	**$29,710**
Cash Flows from Noncapital Financing Activities		
Return of Contributed Capital	($ 11,599)	
Residual Equity Transfer - Dividend	(90,668)	
Net Cash Provided by (Used for) Noncapital Financing Activities	**($ 102,267)**	
Cash Flows from Capital and Related Financing Activities		
Acquisition of Fixed Assets	($ 3,597)	($ 2,114)
Proceeds from Sale of Fixed Assets	15	3
Net Cash Used for Capital and Related Financing Activities	**($ 3,582)**	**($ 2,111)**
Cash Flows from Investing Activities		
Purchase of Investments	($ 185,539)	($ 216,601)
Proceeds from Sales or Maturities of Investments	230,706	153,294
Security Lending Income	(7,403)	8,869
Security Lending Cost	7,023	(8,579)
Interest and Dividends on Investments	33,910	32,131
Net Cash Provided by (Used for) Investing Activities	**$78,697**	**($ 30,889)**
Net Increase (Decrease) in Cash and Cash Equivalents	($ 9,287)	($ 3,290)
Cash and Cash Equivalents July 1	37,477	40,767
Cash and Cash Equivalents June 30	$28,190	$37,477

The notes are an integral part of the financial statements.

Asset-backed securities constitute 32.1 % of the Board of Investment's total STIP portfolio as of June 30, 1997. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constituted 19.7% of the Board of Investment's total STIP portfolio as of June 30, 1996.

Variable rate (Floating Rate) securities make up 32.8% of the Board of Investment's total STIP portfolio as of June 30, 1997. Variable rate securities made up 26.2% of the Board of Investment's total STIP portfolio as of June 30, 1996. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

Long Term Securities

The State Fund invests monies with the Montana Board of Investments, including STIP amounts. Securities are stated at cost and adjusted for amortization of any discount or premium. Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are not included in adjustments to retained earnings.

New Fund Statement of Cash Flows (with comparison to prior fiscal year end)

(thousands of dollars)

	Fiscal Year Ending June 30, 1997	Fiscal Year Ending June 30, 1996 (as restated)
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		
Results of Operations	$30,278	$161,820
Adjustments to Reconcile Operating Income to Net Cash Provided by (Used for) Operating Activities		
Depreciation	552	471
Amortization	76	36
Security Lending Income	(7,403)	8,869
Security Lending Cost	7,023	(8,579)
Interest on Investments	(31,874)	(33,415)
Changes in Assets and Liabilities:		
Decr (Incr) in Accounts Receivable	(350)	5,908
Decr (Incr) in Due From Other Funds	(52)	395
Decr (Incr) in Inventories	9	15
Decr (Incr) in Other Assets	310	815
Incr (Decr) in Accounts Payable	441	(111)
Incr (Decr) in Due to Other Funds	(227)	(232)
Incr (Decr) in Deferred Revenue	(1,287)	(4,074)
Incr (Decr) in Property Held in Trust	(333)	(806)
Incr (Decr) in Estimated Claims	20,630	(101,360)
Incr (Decr) in Compensated Absences	72	(42)
Total Adjustments	($ 12,413)	($ 132,110)
Net Cash Provided by (Used for) Operating Activities	**$17,865**	**$29,710**

The notes are an integral part of the financial statements.

State Fund investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered and held by the Board of Investments or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under loans with cash collateral. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities.

Under the provisions of state statutes, the State Board of Investments has, via a Securities Lending Authorization Agreement, authorized the custodial bank to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the Board's custodial bank on December 1, 1993. During the period the securities are on loan, the Board receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than one hundred percent of the market value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 1997 and 1996, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received U.S. dollar currency cash, U.S. Government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 1997 and 1996 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 1997 and 1996. There were no losses during fiscal years 1997 and 1996 resulting from a default of the borrowers or State Street.

Old Fund Balance Sheet (with comparison to prior fiscal year end)

(thousands of dollars)

Assets	As of June 30, 1997	As of June 30, 1996 (as restated)
Cash in Treasury	$499	$333
Short-term Investment Pool (Note 1)	20,789	7,402
Accounts Receivable (Note 1)	3,613	3,566
Allowance for Doubtful Accounts	(290)	(245)
Due from Other Funds (Note 1)	210	324
Interest Receivable	0	45
Long Term Securities (Note 1)	0	966
Securities on Loan (Note 1)	0	10,143
Cash Collateral - Securities on Loan (Note 1)	560	9,459
Deferred Bond Issue Costs	0	2,938
Total Assets	$25,381	$34,931
Liabilities		
Estimated Claims Liability (Note 4)	$205,678	$248,802
Liability for Securities on Loan	560	9,459
Long Term Bonds Payable (Note 5)	0	129,057
Accrued Bond Interest Payable	0	548
Deferred Revenue	300	228
Due to Other Funds (Note 6)	1,824	1,747
Arbitrage Rebate Tax Payable	156	140
Other Liabilities	45	88
Total Liabilities	$208,563	$390,069
Fund Equity		
Reserved for Debt Service	$0	$14,169
Contributed Capital - New Fund (Note 7)	$90,668	
Retained Earnings	(273,850)	(369,307)
Total Fund Equity	($ 183,182)	($ 355,138)
Total Liabilities and Fund Equity	$25,381	$34,931

The notes are an integral part of the financial statements.

During fiscal years 1997 and 1996, the Board of Investments and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine. On June 30, 1997 and June 30, 1996, the Board had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the cash collateral held for fiscal years 1996-97 and 1995-96 for both the New Fund and the Old Fund:

	New Fund		Old Fund	
	FY96-97	**FY95-96**	**FY96-97**	**FY95-96**
Securities on Loan-Book Value	$94,429,794	$143,771,898	$0	$10,142,650
Securities on Loan-Market Value	$95,792,393	$143,193,462	$0	$9,892,814
Cash Collateral Held	$99,810,560	$137,714,562	$0	$9,118,237

As of June 30, 1997, investments in the New Fund and the Old Fund include $94,429,794 (approximately 21.7% of total long term securities), and $0, respectively, in long term securities on loan which earned interest income during the fiscal year of $7,403,448 and, $187,599 respectively. As of June 30, 1996, investments in the New Fund and the Old Fund included $143,193,462 (approximately 29.7% of total long term securities), and $10,142,650 (approximately 91.3% of long term securities), respectively, in long term securities on loan which earned interest income of $8,868,855 and $112,222, respectively. Securities on loan are classified as risk category 1 or are not categorized.

Montana's Constitution does not currently allow the State Fund to invest in equity securities.

Old Fund Statement of Operations and Changes in Equity
(with comparison to prior fiscal year end)

(thousands of dollars)

	Fiscal Year Ending June 30, 1997	Fiscal Year Ending June 30, 1996
Underwriting Results		
Premium	($ 390)	($ 94)
Claims Expenses:		
Compensation Benefits Paid	10,274	13,940
Medical Benefits Paid	5,648	8,021
Allocated Loss Adjustment Expenses	392	297
Decrease in Actuarially Estimated Claims	(43,124)	(46,946)
Other Expenses:		
Bad Debt Expenses		103
Administrative Expenses	2,800	2,608
Underwriting Gain/(Loss)	$23,620	$21,883
Old Fund Liability Tax Revenue (Note 4)	$49,208	$46,439
Investment Income (Note 1)	2,735	1,160
Security Lending Income (Note 1)	188	112
Security Lending Expense (Note 1)	(170)	(108)
Interest Expense	(2,341)	(8,921)
Bond Arbitrage Expense	(16)	(56)
Results of Operations	$73,224	$60,509
Other Sources/(Uses) of Funds		
Loss on Debt Extinguishment (Note 5)	(3,535)	(1,709)
Net Income	$69,689	$58,800
Contributed Capital - New Fund (Note 7)	90,668	
Residual Equity Transfer - New Fund	11,599	
Prior Year End Fund Equity	(355,138)	(413,938)
End of Period Fund Equity	($ 183,182)	($ 355,138)

The notes are an integral part of the financial statements.

Receivables

The New Fund premium receivable balance of $13,342,342 at June 30, 1997 includes $4.4 million of premium due from insureds for insurance coverage provided during fiscal year 1996-97 not yet received. The remaining $8.9 million represents advanced premiums billed but not received for insurance coverage effective July 1, 1997 as part of the State Fund's Premium in Advance program. This amount is offset in unearned premiums. Estimated uncollectible receivables are reported as an allowance for doubtful accounts of $418,749. Other receivables include $6.6 million in investment income due, and $1.8 million due from the Old Fund in administrative cost reimbursement.

The New Fund premium receivable balance of $13,371,502 at June 30, 1996 includes $4.1 million of premium due from insureds for insurance coverage provided during fiscal year 1995-96 not yet received. The remaining $9.3 million represents advanced premiums billed but not received for insurance coverage effective July 1, 1996 as part of the State Fund's Premium in Advance program. This amount is offset in unearned premiums. Estimated uncollectible receivables are reported as an allowance for doubtful accounts of $317,542. Other receivables include $6.7 million in investment income due, and $1.7 million due from the Old Fund in administrative cost reimbursement.

Accounts receivable in the Old Fund include interest receivable, amounts due from past premiums in dispute or in collection and amounts due from Old Fund Liability Tax collections. Estimated uncollectible receivables are reported as an allowance for doubtful accounts.

Fixed Assets

Equipment is valued at actual or estimated historical cost. Depreciation expense is computed on a straight-line basis for equipment over a period of five to ten years. Amortization of intangible assets is computed on a straight-line basis over a period of three to seven years and is applied directly to the asset balance. All fixed assets are recorded in the New Fund. Because the State Fund administers the Old Fund, the Old Fund does not carry fixed assets.

Old Fund Statement of Cash Flows (with comparison to prior fiscal year end)

(thousands of dollars)

	Fiscal Year Ending June 30, 1997	Fiscal Year Ending June 30, 1996
Cash Flows from Operating Activities		
Receipts for Sales and Services	($ 388)	($ 22)
Payments to Suppliers for Goods and Services	(1,683)	(1,023)
Payments to Employees	(1,053)	(1,120)
Cash Payments for Claims	(16,332)	(22,300)
Collections of Notes Receivable	29	(36)
Other Operating Revenues	49,229	43,258
Net Cash Provided by (Used for) Operating Activities	$29,802	$18,757
Cash Flows from Noncapital Financing Activities		
Payment of Principal and Interest on Bonds and Notes	($ 129,008)	($ 44,050)
Operating Transfers Out		($ 638)
Operating Transfers In		($ 114)
Transfers from Primary Government		$27,426
Contributed Capital - New Fund	90,668	
Residual Equity Transfer - New Fund	11,599	
Loss on Debt Extinguishment	(3,535)	(1,709)
Net Cash Provided by (Used for) NonCapital Financing Activities	($ 30,276)	($ 19,085)
Cash Flows from Investing Activities:		
Purchase of Investments		($ 5,038)
Proceeds from Sales or Maturities of Investments	11,100	4,627
Securities Lending Income	187	112
Securities Lending Expense	(170)	(108)
Interest and Dividends on Investments	2,910	1,483
Net cash Provided by (Used for) Investment Activities	$14,027	$1,076
Net Increase (Decrease) in Cash and Cash Equivalents	$13,553	$748
Cash and Cash Equivalents, July 1	$7,735	$6,987
Cash and Cash Equivalents, June 30	$21,288	$7,735

The notes are an integral part of the financial statements.

Advanced Deposits
Security deposits are deposits by certain policyholders which secure payment of premiums.

Unearned Premiums
Unearned premiums reflect amounts in advance that are received or billed, but not yet earned for policies effective July 1, 1997 or July 1, 1996.

Premiums
Premium rates are approved by the State Fund Board of Directors. Policies are effective July 1 through June 30 of each year. Revenue from premiums is recognized over the term of the year.

Policyholders are contractually obligated to pay certain premiums to the State Fund in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by the State Fund.

Fund Equity
Fund Equity consists of the net excess or deficit of assets over liabilities.

Presentation
The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. State Fund insurance operations are classified as an Enterprise Fund, Proprietary Fund type.

The Enterprise Fund of the State Fund is part of, but does not comprise, the entire Enterprise Fund of the State of Montana. The financial statements in this report reflect the financial position and results of operations and cash flows of the State Fund (New Fund and Old Fund), not the State of Montana.

Old Fund Statement of Cash Flows (with comparison to prior fiscal year end)

	(thousands of dollars) Fiscal Year Ending June 30, 1997	Fiscal Year Ending June 30, 1996
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating Income (Loss)	$73,224	$60,509
Adjustments to Reconcile Operating Income to Net Cash Provided by (Used for) Operating Activities:		
Interest Expense	$2,340	$8,921
Securities Lending Income	(188)	(112)
Securities Lending Expense	170	108
Interest on Investments	(2,735)	(1,160)
Arbitrage Rebate Tax	16	56
Change in Assets and Liabilities:		
Decr (Incr) in Accounts Receivable	(167)	(2,764)
Decr (Incr) in Due From Other Funds	114	(502)
Decr (Incr) in Other Assets		64
Incr (Decr) in Accounts Payable	15	
Incr (Decr) in Due to Other Funds	77	411
Incr (Decr) in Deferred Revenue	72	228
Incr (Decr) in Estimated Claims	(43,124)	(46,946)
Incr (Decr) in Other Liabilities	(12)	(56)
Total Adjustments	(43,422)	(41,752)
Net cash provided by (Used for) Operating Activities	**$29,802**	**$18,757**

The notes are an integral part of the financial statements.

The Enterprise Fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

Effective July 1, 1996 the Governmental Accounting Standards Board (GASB) implemented Statement No. 28 - Accounting and Financial Reporting for Securities Lending Transactions. The financial statements for the fiscal year ended June 30, 1996 have been restated to compare with the financial statements for the fiscal year ended June 30, 1997.

GASB Statement No. 28 requires the costs of securities lending transactions to be recorded separately instead of netted against related income. This statement also requires investments, such as STIP, to allocate, on a pro rata basis, each participant's share of security lending income, expense and cash collateral.

2. Investments

The amortized cost and market value of the New Fund fixed maturity securities as of June 30, 1997, and June 30, 1996, are as follows:

June 30, 1997	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
US Treasury Securities	$108,487,612	$2,443,459	($955,831)	$109,975,240
US Government Agencies and US Government Guaranteed Securities	$79,126,315	$459,147	($971,965)	$78,613,497
Corporate Securities Asset Backed	$65,590,669	$134,274	($120,265)	$65,604,678
Other Corporate Securities	$177,197,105	$3,281,350	($747,567)	$179,730,888
Other Securities	$4,995,284	$266,016		$5,261,300
STIP	$25,472,672			$25,472,672
Totals	**$460,869,657**	**$6,584,246**	**($2,795,627)**	**$464,658,275**

June 30, 1996	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
US Treasury Securities	$156,389,075	$2,483,885	($2,084,150)	$156,788,810
US Government Agencies and US Government Guaranteed Securities	$79,849,933	$272,804	($1,665,598)	$78,457,139
Corporate Securities Asset Backed	$64,207,859	$30,815	($346,834)	$63,891,840
Other Corporate Securities	$165,954,335	$2,702,624	($1,881,353)	$166,775,606
Other Securities	$14,900,755	$298,144	($207,799)	$14,991,100
STIP	$36,254,100			$36,254,100
Totals	**$517,556,057**	**$5,788,272**	**($6,185,734)**	**$517,158,595**

The amortized cost and estimated market value of fixed maturity securities as of June 30, 1997 and June 30, 1996, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
June 30, 1997		
Due one year or less	$ 36,576,315	$36,680,505
Due after one year through five years	129,895,316	130,659,507
Due after five years through ten years	217,001,659	218,127,758
Due after ten years	77,396,367	79,190,505
Totals	$460,869,657	$464,658,275
June 30, 1996		
Due one year or less	$ 36,254,100	$36,254,100
Due after one year through five years	194,026,361	194,870,545
Due after five years through ten years	197,106,432	195,141,970
Due after ten years	90,169,164	90,891,980
Totals	$517,556,057	$517,158,595

During fiscal year ending June 30, 1997, the New Fund realized gross gains from sales of securities of $1,532,941 and gross realized losses of $861,696. During fiscal year ending June 30, 1997, the Old Fund realized $2,474,238 in gross gains from sales of securities and $275,636 in gross realized losses. During fiscal year ending June 30,1996, the New Fund realized gross gains from sales of securities of $1,534,643 and gross realized losses of $725,678. During fiscal year ending June 30, 1996, the Old Fund realized no gross gains from sales of securities and $11,089 gross realized losses.

Long term securities in the Old Fund of $11,109,374 at June 30, 1996 were required debt service reserve deposits related to long term workers' compensation program bonds. The market value of these securities was $9,892,814 at June 30, 1996. Old Fund STIP balance at June 30, 1996 included $2.8 million in required debt service reserve deposits for variable rate payroll tax bonds. As of June 30, 1997, all long term workers compensation program bonds had been either retired or defeased. Invested assets are no longer needed to secure debt service reserve requirements.

3. Reinsurance

For the two fiscal years ended June 30, 1997 the State Fund ceded reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts which protect against losses over stipulated amounts. During both fiscal years, the State Fund retained the first $1.25 million of each loss and $750,000 in aggregate annual deductible, while reinsurers were liable for losses in excess of $2 million up to a limit of $50 million on occurrences involving multiple claimants. Individual, per person coverage was provided up to $5 million per claimant with the State Fund retaining the first $2 million. This per person coverage is subject to an annual limit of $10 million. In the event reinsurers are unable to meet their obligations, the State Fund would remain liable for all losses as the reinsurance agreements do not discharge the State Fund from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $333,564 and $519,421 in fiscal years 1996-97 and 1995-96, respectively.

Reinsurance had no effect on fiscal year 1995-96 or fiscal year 1996-97 losses and loss adjustment expenses.

4. Risk Management/Public Entity Risk Pool

The Old and New Funds are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims, including the effects of inflation and other socioeconomic factors.

The New Fund provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund must insure any employer who desires coverage. At fiscal year-end June 30, 1997, approximately 24,823 employers were insured by the New Fund. At June 30, 1996, approximately 25,474 employers were insured with the New Fund. Anticipated investment income is considered when computing premium rate levels and employers must pay premiums to the State Fund within specified time frames.

Tillinghast-Towers Perrin prepared an actuarial study and estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported for the New Fund as of June 30, 1997 and June 30, 1996. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 1997, $344,632,133 of unpaid claims and claim adjustment expenses are presented at their net present value of $315,107,230, discounted at an annual rate of 4% on indemnity losses and no discount on medical losses. As of June 30, 1996, $402,714,180 of unpaid claims and claim adjustment expenses are presented at their net present value of $294,477,691. These claims are discounted at an annual rate of 5.75% for both indemnity and medical losses. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of the New Fund is terminated.

State law requires the New Fund to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. State law also requires the State Fund to establish a minimum surplus balance of 25% of annual premium revenue.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments is provided by Old Fund Liability Taxes (OFLT) imposed on employer payroll (0.5%), employee wages (0.2%), and sole proprietor and subchapter S shareholder distributive income (0.2%). The OFLT provides funding for Old Fund claim expenses and Old Fund bond payments (see note 5).

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 1997, was used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported. As of June 30, 1997, $205,678,392 of unpaid claims and claim adjustment expenses are presented at face value. As of June 30, 1996, $248,802,467 of unpaid claims and claim adjustment expenses are presented at face value. Total Old Fund deficit as of June 30, 1997 is $183,182,203 compared to a deficit of $355,138,342 as of June 30, 1996. Estimated claims liability for the Old Fund is presented on an undiscounted basis.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes (in thousands) in the aggregate liabilities for the New Fund and the Old Fund for the past two years. The information presented has not been discounted.

	New Fund		Old Fund	
	1997	1996	1997	1996
Unpaid claims and claim adjustment expenses at beginning of year	$402,714	$541,374	$248,802	$295,748
Incurred claims and claim adjustment expenses:				
Provision for insured events of the current year	81,046	102,102		
Increases (decreases) in provision for events of prior years	(80,752)	(169,235)	(26,812)	(24,688)
Total incurred claims and claim adjustment expenses	294	(67,133)	(26,812)	(24,688)
Payments:				
Claims and claim adjustment expenses attributable to insured events of the current year	(12,589)	(15,818)		
Claims and claim adjustment expenses attributable to insured events of prior year	(45,787)	(55,709)	(16,312)	(22,258)
Total Payment	**(58,376)**	**(71,527)**	**(16,312)**	**(22,258)**
Total unpaid claims and claim adjustment expenses at end of the year	**$344,632**	**$402,714**	**$205,678**	**$248,802**

Risk Management Trend Information

The following table illustrates (in thousands) how the earned revenues of the New Fund plus investment income compare to related costs of loss and other expenses assumed by the State Fund for fiscal years 1991 through 1997. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and reestimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

New Fund	1991	1992	1993	1994	1995	1996	1997
1. Net earned required contribution and investment revenues	$115,656	$151,256	$195,216	$208,736	$174,015	$121,646	$88,014
2. Unallocated expenses including overhead	6,048	8,232	9,325	9,090	11,303	16,114	11,374
3. Estimated ultimate incurred claims and expenses:							
End of policy year	137,237	183,425	186,480	199,890	173,327	102,102	81,046
4. Paid (cumulative) as of:							
End of policy year	17,618	20,244	18,347	18,693	18,137	15,818	12,589
One year later	44,335	50,576	46,343	45,947	40,473	32,890	
Two years later	64,079	68,837	62,717	60,971	52,073		
Three years later	74,901	77,950	71,666	67,576			
Four years later	81,747	83,173	76,280				
Five years later	85,924	86,461					
Six years later	88,532						
5. Reestimated ultimate incurred claims and expense:							
End of policy year	$137,237	$183,425	$186,480	$199,890	$173,327	102,102	81,046
One year later	166,980	184,968	184,030	184,920	124,123	88,923	
Two years later	160,272	175,218	167,052	135,472	107,074		
Three years later	151,554	161,184	133,017	116,756			
Four years later	141,389	135,775	120,583				
Five years later	130,250	125,084					
Six years later	121,568						
6. Increase (decrease) in estimated incurred claims and expense from end of policy year	(15,669)	(58,341)	(65,897)	(83,134)	(66,253)	(13,179)	

5. Payroll Tax Bonds (Workers' Compensation Program)

The Montana Board of Investments issued $142,095,000 of bonds on July 15, 1991 (Workers' Compensation Program Series 1991), for the purpose of funding the state's liability and costs in administering and paying claims for injuries resulting from accidents prior to July 1, 1990, that are subject to the Montana Workers' Compensation Act and the Occupational Disease Act of Montana.

Using cash determined by the State Fund to be in excess of the amount needed to pay claims occurring prior to July 1, 1990, the Board of Investments provided for two early defeasances of $20,880,000 and $13,075,000 in the Workers' Compensation Program Series 1991 bonds. On July 24, 1995 and March 26, 1996, the Board deposited $21,528,449 and $13,521,916, respectively, with an escrow agent and invested in federal securities to provide for the future debt service payments until the bonds mature through June 1, 2020. Both transactions met the requirements of a legal defeasance. The $20,880,000 and $13,075,000 in Series 1991 Bonds maturing through June 1, 2020 were removed from the State Fund's accounting records in July 1995 and March 1996. The fiscal year 1996 loss related to these early bond defeasances totaled $1,709,046. This amount relates to the write-off of original bond discount and cost of issuance and bond premium paid for early redemption.

Using cash from the declaration of a dividend, cash available from the bond reserve and cash determined by the State Fund to be in excess of the amount needed to pay claims occurring prior to July 1, 1990, the Board of Investments provided for the final retirement of $97,885,000 in Workers' Compensation Program Series 1991 bonds. On October 3, 1996, the Board deposited $99,384,056 with an escrow agent and invested in federal securities to provide for the future debt service payments until the bonds mature through June 1, 2020. The transaction met the requirements of a legal defeasance. The $97,885,000 in Series 1991 bonds maturing through June 1, 2020 were removed from the State Fund's accounting records in October 1996. The fiscal year loss related to the bond defeasance totaled $3,208,210. The net loss constitutes a final write-off of the original bond discount and cost of issuance which was being amortized over the life of the bonds and a gain associated with the federal securities acquired for the defeasance.

In completing the three bond defeasances described above, the Board of Investments reserved the right to substitute other government securities or cash into the Workers' Compensation Program Series 1991 escrow as long as the substitution was sufficient to retire the bonds. In December 1996 the Board of Investments chose to sell an option to a third party to purchase the escrowed securities on or after November 1, 2008 for a price sufficient to redeem all the Series 1991 bonds. The bid process resulted in net option premium proceeds of $2,284,940 to maximize the yield of the escrowed securities. These proceeds, received on January 3,1997 and recorded in the Old Fund, reflected investment gain and expense of $2,456,310 and $171,370, respectively.

On October 27, 1993, the Board of Investments issued $32,500,000 in Variable Rate Payroll Tax Bonds (Workers' Compensation Program Series 1993) to pay the costs associated with claims incurred on or before June 30, 1990.

Using cash from the declaration of a dividend, cash available from the bond reserve and cash determined by the State Fund to be in excess of the amount needed to pay claims occurring prior to July 1, 1990, the Board of Investments provided for the full retirement of $32,500,000 in Workers' Compensation Program Series 1993 bonds. On January 2, 1997 the Board of Investments paid $32,604,037, principal and interest, to the trustee as final payment on the Series 1993 bonds. The transaction met the requirements of a legal defeasance. The fiscal year 1997 net loss related to the bond redemption totaled $326,990. The net loss represents the final write-off of the cost of issuance which was being amortized over the life of the bonds.

6. Administrative Cost Allocation

State law requires the State Fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund to $3 million. The State Fund allocated $2.975 million and $3.0 million in administration costs to the Old Fund in fiscal years 1996-97 and 1995-96, respectively. The Old Fund has a $1,144,189 obligation to the New Fund in unrecovered administrative costs in previous years. The New Fund intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $3 million.

7. Dividend Paid to the Old Fund

On September 24, 1996, the Board of Directors of the State Fund declared a dividend not to exceed $109 million from excess surplus funds payable to the Old Fund. According to state law, any dividends declared must be used to pay off the Old Fund liability.

As part of the total dividend, an amount not to exceed $12 million was designated as a return of the New Fund's contributed capital. The $12 million repayment was also applied to repayment of the Old Fund liability.

The State Fund Board of Directors instructed the State of Montana Board of Investments to use the allocated excess surplus funds to retire the outstanding Old Fund bond debt (see Note 5).

8. Compensated Absences

Employees at the State Fund accumulate both annual and sick leave. The State Fund pays employees for 100% of unused annual leave and 25% of unused sick leave upon termination. The fund pays 100% of unused compensatory leave credits upon termination to nonexempt employees. The State Fund absorbs expenditures for termination pay in its annual operational costs. The State Fund had a total leave liability of $709,749 and $650,689 at June 30, 1997, and June 30, 1996, respectively.

9. Pension Plan

The State Fund and its employees contribute to the Public Employees Retirement System (PERS), a mandatory multiple-employer, cost-sharing, defined benefit pension plan administered by the State of Montana Public Employees Retirement Division (PERD). The PERS offers retirement, disability and death benefits to plan members and their beneficiaries. Established in 1945, the plan is governed by Title 19, Chapters 2 and 3, MCA. PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. Actuarially reduced retirement benefits may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average salary. Vesting occurs once membership service totals 5 years. The authority to establish and amend contribution rates and to provide cost of living adjustments for the plan is assigned to the State legislature. State Fund and its employees each were required to contribute 6.7% of annual compensation in fiscal years 1996-97, 1995-96, and 1994-95. This amounted to $826,442 for fiscal year 1996-97, $829,188 for fiscal year 1995-96, and $788,342 for fiscal year 1994-95. One hundred percent of required contributions were paid to PERS by State Fund and its employees and there is no unpaid liability as of June 30, 1997.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from the PERD at 1712 Ninth Avenue, P. O. Box 200131, Helena, MT 59620-0131, 406/444-3154.

10. Building

The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. As of July 1, 1990, the State Fund transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under the agreement, the State Fund will pay all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. Contingencies

In prior years the State Fund purchased single premium annuities from Confederation Life Insurance Company (the Company), Atlanta, Georgia to settle claims. The Company has been placed in bankruptcy rehabilitation by the Michigan Insurance Department. State Fund legal counsel has reviewed the rehabilitation plan (Plan) of Confederation Life Insurance Company. There were twelve Old Fund claims with annuities with the Company. The outstanding balances on the annuities amount to $510,192. The Plan anticipates full payment of annuity contracts. State Fund will continue to monitor the execution of the Plan.

Broeker v. State Fund The issue in this case involved the way insurers calculate the social security disability insurance (SSDI) offset rates on certain claims. The Workers' Compensation Court decision stated that, where there is a cost of living increase built into the initial entitlement to social security disability benefits, the workers' compensation insurer cannot take the cost of living increase into consideration when computing the SSDI offset rate. On appeal, the Montana Supreme Court affirmed the Workers' Compensation Court decision. This decision affects prior unsettled claims and similarly situated claimants that will receive benefits in the future. Because these claims have not been identified, no calculation of potential benefits due has been made. This matter is currently before the Workers' Compensation Court as to whether this can be certified as a class action.

12. Subsequent Event

The 1997 session of the Montana Legislature passed and Governor Racicot subsequently signed Senate Bill 67.

Senate Bill 67 provides for the payment of $20 million by the State Fund to the State of Montana General Fund at the rate of $10 million in fiscal year 1997-98 and $10 million in fiscal year 1998-99. This will reimburse the State of Montana General Fund for a $20 million appropriation made to the Old Fund during the June 1989 Special Session of the Montana Legislature.

In addition, the New Fund will transfer $63.8 million to the Old Fund during fiscal year 1997-98 in order to provide sufficient funding for future payment of Old Fund claims.

Robert F. Conger
FCAS, MAAA, FCIA
Principal

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Atlanta, GA 30326-1119
404 365-1634
Fax: 404 365-1167

Tillinghast - Towers Perrin

February 27 1998

To Members of the State Fund Board of Directors:

Tillinghast – Towers Perrin was engaged by the Montana State Compensation Insurance Fund (the Fund) to estimate the unpaid loss and loss adjustment expenses as of June 30, 1997, for the Fund's workers compensation exposures. We examined both the New Fund and the Old Fund, using data evaluated as of June 30, 1997. We relied on Fund personnel as to the completeness and accuracy of the data.

For the New Fund, our estimated loss and loss adjustment expense liability as of June 30, 1997, is $344.6 million undiscounted. The Fund has recorded a provision of $315.1 million for unpaid loss and loss adjustment expense, on a discounted basis, as of June 30, 1997.

For the Old Fund, our estimated loss and loss adjustment expense liability as of June 30, 1997, is $205.7 million, undiscounted. The Fund has recorded a provision of $205.7 million on its June 30, 1997 balance sheet for unpaid loss and loss adjustment expense.

The Total Fund Equity of the New Fund as of June 30, 1997, with loss and loss adjustment expense liability expressed on a discounted basis, is $159.4 million. Current year premium revenue was $89.1 million. We note that the New Fund surplus level is consistent with traditional industry standards. We believe that it is prudent for the Fund to set a long-term goal of maintaining surplus based on industry standards.

VARIABILITY

Loss and loss adjustment expense reserve estimates are subject to considerable uncertainty due to the fact that the ultimate liability for claims is subject to the outcome of events yet to occur. Additional uncertainty is introduced in estimating unpaid loss and loss adjustment expense on a present value basis. That is, besides the risk of underestimating or overestimating the overall amount of the loss and loss adjustment expense liabilities, there is the additional risk that the timing of the future payment of those liabilities will differ from the estimated payout, or that the future yield on the underlying assets will differ from the assumed interest rate.

Robert F. Conger
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries

Report of Management

The management of the State Compensation Insurance Fund is responsible for the financial statements and all other information presented in this annual report. The financial statements were prepared in conformity with generally accepted accounting principles and include amounts based on the best estimates and judgements of management.

The State Fund maintains a system of internal control. The system of internal control is designed to provide reasonable assurance that assets are safeguarded against loss and transactions are executed and recorded in accordance with management's authorization. The system of internal control encompasses the organizational structure, selection and training of personnel, communication, and enforcement of policies and procedures. The system of internal control is continually reviewed and evaluated by management.

The balance sheet and related statements of operations and changes in fund balance, and cash flow at and for the periods ending June 30, 1997, and June 30, 1996, presented in this report were audited by independent auditors of the State of Montana, Legislative Audit Division. Their opinion is included in this report.

Men and Women of the State Fund

Employees as of December 31, 1997

Monica Abbott • Charlie Adams • Sandy Adams • Deanna Albert • Ginny Amdahl • Susan Amicucci • Andy Anderson • Denise Baird • Lesley Barrett • Mark Barry • Kevin Bartsch • Ed Benasky • Valerie Bender • Carolyn Bendinelli • Sarah Bennett • Dwight Bernard • Ed Binkley • Rita Bird • Bruna Bizzotto • Doreen Black • Michael Blades • Kris Brandt • Deborah Brebner • Connie Brooks • Patrick Brown • Greg Bryan • Shawn Bubb • Nancy Butler • Sherry Carroll • Daisy Carsen • Sherrie Chenovick • Enid Christenson • Lori Clare • Ann Clark • Richard Clark • Shannon Copps • Brad Cozzie • Chuck Crawford • Billy Cross • Denise Cummins • Kim Davis • Jean Davis • Dale DeHart • Kathy Devereaux • Wayne Dillavou • Tom Disburg • Lucinda Dixon • Lynn Donnelly • Carol Dullum • Shaun Dunfee • Darcie Dunlap • Teresa Eaton • Jo Eidum • Kim Erickson • Val Ewals • Connie Ferriter • Tim Fitzpatrick • Debby Flanssas • Kathryn Fleming • Joyce Flynn • Shauna Foley • Sandra Folsom • Dwan Ford • Kathy Frandsen • Cathy French • Tom Fritch • LaVonne Garver • Lisa Gates • Dan Gengler • Lila Geske • Blaine Gilbert • Kristy Gilbert • Michael Glass • Jeannie Glenn • Dan Glenny • John Gneckow • Linda Goan • Richard Gobbs • Ester Grant • Holly Green • Mary Green • Donna Gregg • Deena Gunstone • Kathy Hall • Myrna Hammond • Kelli Hargreaves • Linda Harmon • Joe Harrilla • Mary Heare • Marti Heaton • Denise Heigh • Katie Herrera • Bernie Hewitt • Jeff Hilger • Vickie Hirschi • Beth Hohn • Barbara Holshue-Dudley • Virginia Horvath • Lanny Hubbard • Nance Hughes • James Hultin • Pat Hunt • Deborah Hunter • Regina Huot • Carla Irby • Rae Jerrel • Teresa Job • Darcy Johnson • Blair Johnson • Linda Johnson • Yvonne Johnson • Ben Jones • Todd Jones • Enid Kalaher • Mark Karvelis • Jean Ketchel • Barb King • Linda Kirkeby • Marvin Kraft • Lauree Kramer • Karen Kueffler • Wendy Lee • Sandy Leyva • Jonathan Linder • Karen Longmire • Fred Lubke • Randy Marcus • Tom Martello • Gail Martin • Gary Martinez • Mary Martinez • Lee McBride • Jim McCluskey • Jim McCormick • Cris McCoy • Chip McKenna • Carolyn McLeod • John McMahon • Mark Meismer • Randal Merrick • Dave Miller • Karen Miser • Lulu Mitton • Lynn Mogstad • Denise Molley • Linda Montgomery • Susan Moore • Carol Morris • Crystal Murphy • Bonita Murray • Marilyn Murray • Aidan Myhre • Larry Nelson • Eivind Nilsen • Pat Nistler • Nancy O'Dell • Dave Ogan • Elizabeth Olsen • Shannon Olson • Helen Osterloth • Diane Pedersen • Bob Pennington • Melodie Phalp • Nancy Phillips • Rita Potts • Nanette Preszler • Robin Pugh • Rebecca Rabey • Mary Lynn Ramsey • Bev Rankin • Sandra Ricon • Marie Ringle • Stacy Ripple • Linda Robbins • Cecelia Robinson • Trudy Robinson • Brenda Rogelstad • Rosemarie Roseland • Bonnie Rouse • Keri Routzahn • Kathy Rowsey • Judy Russell • Azmi Salaymeh • Mitzie Saltzman • Johnny Samples • Barb Sauter • Bridget Scevers • Steven Scholl • Marilyn Schultz • Sheryl Semans • Stacie Sheldon • Carol Shute • Joanne Shydian • Bob Silberling • Mary Simpson • Inez Slayman • Dennis Small • Brent Small • Michael Smart • Lorna Smith • Tony Sperle • Terry St. Clair • Kelly Stanley • Jack Stewart • Linda Stockie • Debbie Svaldi • Carl Swanson • Mona Tangen • John Thomas • Lawrence Thomas • Timothy Tindall • Gary Tufflie • Patricia Turner • Barbara Van Der Mars • Chantal VanDaele • Lois Vick • Bill Visser • Vi Walchuk • Tammy Walczak • Harry Walker • Linda Ward • Karen Wegner • Laurie Weidlich-Kuntz • Christy Weikart • Michael Welsh • Judi Whitney • John Wilkins • Ray Williams • Sharon Williams • Susan Witte • Holly Wood • Hank Worsech • Jim Worthington • Aimee Wortman

A Montana State Fund Update for Legislators

The Montana State Fund has been busy since the end of the 1997 Legislative session and we wanted to take the opportunity to share with you an update of our progress. We remain committed to providing quality customer service and managing our resources effectively.

Agency Program is a Success

With your support and leadership, Senate Bill 67 authorized us to provide service to our customers through licensed insurance producers. This change has restructured, in large part, the way we conduct business. Partnering with licensed insurance producers in local Montana communities facilitates our ability to add value to our products and services. This important relationship provides customers an opportunity to work with one producer for all their insurance needs, if they desire, and increases the level of information shared with Montana employers.

In July 1997, we launched a pilot program with a limited number of agencies to design and cultivate the program. The pilot program was a success. Then in January, we launched our comprehensive agency program adding additional agencies throughout Montana to our initial "pilot" agencies. An important component of the program's success is the valuable training provided to producers. We have conducted a full day training session for each of these producers which have been very well received.

When a customer is represented by a producer, the State Fund maintains contact with both the producer and the customer. Producers work directly with the customers to save costs, encourage return to work opportunities, and improve safety in the work place. This value-added relationship serves businesses and individuals through the producers' knowledge of the customers' business and their accessibility.

New Board Members

Senate Bill 67 expanded the State Fund Board of Directors from five members to seven members to add more business expertise. The State Fund is pleased to announce the addition of Brian Donahue of Billings and Lorretta Lynde of Helena to our Board. Both members were appointed by Governor Racicot. Brian Donahue is the Managing Vice President of Hoiness LaBar Insurance Agency and his appointment fills the "licensed insurance producer" vacancy. Lorretta Lynde owns a management consulting business and she brings extensive experience in human resources, marketing, and management to the Board.

Employers Liability Coverage Offered March 1

As a result of Legislation passed in 1995 which authorized the State Fund to provide employers liability coverage to customers, the State Fund has recently unveiled this new product to all customers. This additional coverage, also known as "Part Two Coverage," is offered at basic limits for no additional cost. Employers Liability coverage is designed to provide additional insurance coverage for the liability of the employer for bodily injury or disease to employees not covered by the workers' compensation policy. It may apply in cases where the "exclusive remedy" provisions of the workers' compensation law does not apply. This new coverage is another example of how the State Fund is striving to add value to its products and services to better serve Montana employers.

Dividends

The State Fund Board of Directors received authority from the Legislature, as a part of SB67, to pay dividends to deserving policyholders after July 1, 1998. We are in the process of developing a dividend program that incorporates typical features of dividend plans in use by other state funds. Any future dividend declaration would be contingent upon Board approval, recommendations from our consulting actuary, and only if an excess surplus exists. I do not believe the State Fund will be in a position to consider a dividend until after the Old Fund is fully funded and the tax is ended.

Spreading the Word

In today's complex insurance world, customers often need more information about products and services while insurance carriers need more avenues for marketing and distributing pertinent information. In addition, to maintain a healthy workers' compensation industry, insurance carriers must provide the confidence and stability that customers depend on. The State Fund recognizes the need to maintain an appropriate balance of customers, both large and small, to ensure our financial strength and long term viability. As we compete for a balanced book of large and small policyholders, larger premium volumes allow us to spread our fixed costs over a larger base, create economies of scale, and reduce volatility of financial results to ensure stable workers' compensation rates. To be successful, we must offer the same competitive services and programs provided by other state funds and private carriers. If we fail to be competitive, premiums for employers in Montana will increase dramatically.

To ensure State Fund remains a viable guaranteed market, we must operate differently than in the past. Our new network of insurance producers provides one critical avenue for distribution of products, services, and information. Another important avenue is "educational based marketing." The State Fund shares information with customers to enhance their understanding of workers' compensation issues and to enable them to reduce costs through effective safety programs and claim management. We are taking a proactive approach to communicating information about new programs and services while promoting the benefits of safety, early reporting, and early return to work programs. We are confident this information will better control workers' compensation premiums and improved confidence in our system.

Old Fund Liability Tax Update

In passing Senate Bill 67, the Legislature provided for a mechanism which requires review of several factors relating to the financial status of the Old Fund and then for termination of the Old Fund Liability Tax, once the factors are met. These reviews ensure that Old Fund claims are adequately funded. The State Fund consulting actuary will determine the remaining unpaid liability and when the Old Fund will be fully funded to eliminate the tax. The Old Fund is considered to be fully funded when there are enough assets set aside to pay the remaining liabilities and provide for a 10% contingency to offset possible adverse development, such as a court decision. Also pursuant to SB67 was a payment by the State Fund of $63.8 million in FY98. Based on information received by the consulting actuary, the Old Fund, although not adequately funded at this time, is estimated to be fully funded in December 1998, and no later than July 1999. A full actuarial analysis will occur at the end of FY98 with a report available by September. When the Old Fund is adequately funded, the State Fund Board of Directors will advise the Budget Director, who will notify the Department of Revenue to terminate collecting the tax.

Other States Coverage

As a way to help the State Fund coordinate the workers' compensation insurance needs of our policyholders who reside in Montana and have workers' compensation business needs outside of the state, Senate Bill 67 authorized the State Fund to offer Other States Coverage. Due to the complexity of providing Other States Coverage, the State Fund is exploring various options for implementing the coverage for our customers. We anticipate this coverage will be available at the end of the calendar year.

General Fund Payments

Senate Bill 67 provided for a two payments from the State Fund to the General Fund: $10 million in FY98 and $10 million in FY99. The State Fund will make the first payment of $10 million on June 30, 1998.

If you have questions regarding this information or other State Fund information, please contact me at 444-6501. Thank you for this opportunity to share our exciting news.

Carl Swanson
President/CEO

1,500 copies of this public document were published at an estimated cost of $1.57 per copy for a total cost of $3,250, which includes $2,350 for printing and $900 for distribution. Alternative formats of this material will be provided upon request. Persons needing accommodation should contact Aidan Myhre at 406-444-5982.